GIFT PLANNING TO SAVE TAXES

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THE IMMEDIATE PROBLEMS

One of the immediate problems confronting Earl Beaver is that with a $70,000 annual income he finds himself in an extremely high income tax bracket, and he is paying out approximately $26,000 a year in income taxes.

Another problem, which he does not really appreciate until we orient him, is that on his and his wife's deaths their $420,000 of property will be reduced by between $90,000 and $120,000 under their present wills, on account of federal estate taxes.[1] This, of course, is not a tax on income; it is a capital levy, reducing the amount of property they could pass on to their children.

Some of the considerations involved in reducing the Beavers' estate and income taxes without loss of their property are discussed *infra.*

But equally important, and too often not adequately considered, are the even greater advantages of making some immediate gifts of income-producing property within the family. Such gifts may effect immediate income tax savings by shifting income away from the high income tax brackets of the head of the family and into the lower income tax brackets of the donees. At the same time they will save estate taxes by cutting down the donor's taxable estate. Accordingly, the first subject to which we address ourselves is the subject of gifts.

AMOUNTS WHICH MAY BE GIVEN AWAY FREE OF GIFT TAX

It is well known—and there is no need to dwell on the technical rules in this discussion—that by taking advantage of the gift-splitting provisions of the law,[2] the annual $3,000 gift tax exclusion,[3] and the $30,000 lifetime gift tax exemption,[4] a married couple can give away

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1 The computation of those federal estate taxes, assuming their present estates remain intact, is briefly as follows:

Estate tax if Earl predeceases Betty	
On Earl's death (approximately)	$ 30,000
On Betty's death (approximately)	90,000
Aggregate	$120,000
Estate tax if Betty predeceases Earl	
On Betty's death	$ -0-
On Earl's death (approximately)	90,000
Aggregate	$ 90,000

2 INT. REV. CODE OF 1954, § 2513.

3 INT. REV. CODE OF 1954, § 2503(b).

4 INT. REV. CODE OF 1954, § 2521.

very substantial amounts entirely free from any gift tax. For example, assuming advantage were taken of the gift-splitting provision of the law, in 1958 Earl Beaver could make gifts of $24,000 within his and his wife's gift tax exclusions (they have two children and two grandchildren), and in addition he could give away $60,000 within his and his wife's lifetime exemption—an aggregate of $84,000 in one year. If we look at a five-year stretch, Beaver could give away $24,000 per year for five years or an aggregate of $120,000 within the gift tax exclusions, plus $60,000 within his and his wife's lifetime exemption, or an aggregate of $180,000 over a five-year period. Obviously, even in an estate as large as the Beavers', the gift tax is not much of a factor.

Reasons Why Even Taxable Gifts May Save

Moreover, and this is an aspect of family tax planning which is often overlooked, even taxable gifts will almost always save transfer taxes—for at least four reasons.

The first reason is that the gift tax rates are substantially lower than the estate tax rates. Thus, for example, the estate tax rate on the portion of a taxable estate falling in the $100,000 to $250,000 estate tax bracket is 30 per cent.[5] The gift tax rate on taxable gifts falling in the $100,000 to $250,000 gift tax bracket is only 22½ per cent.[6]

Secondly, and more important, in making gifts the donor will be removing property from his estate in his top estate tax bracket, whereas ordinarily the gift will fall not in the corresponding gift tax bracket but in a much lower, or a zero, gift tax bracket. Let us assume, for example, that Beaver were to make a taxable gift to his children of $100,000. Furthermore, for simplicity, let us assume that Beaver has no lifetime exemption or gift tax exclusion available, and that no prior taxable gifts have been made; and let us ignore the estate tax marital deduction. The result of that $100,000 gift would be to remove $100,000 from Beaver's estate tax bracket at the $250,000 to $350,000 level, where the estate tax rates are 32 per cent. But the $100,000 gift will not be taxed for gift tax purposes in the $250,000 to $350,000 gift tax bracket; instead, it will fall in the zero to $100,000 gift tax bracket where the gift tax rates start at 2¼ per cent. That is, the gift comes off at the top of the estate tax ladder and is inserted at the bottom of the gift tax ladder, on top only of prior gifts.

The third reason why gifts save transfer taxes is that the gift tax is a net tax, whereas the estate tax is a gross tax. Take that same $100,000 gift. If Beaver were to make that gift, the gift tax would be computed by applying the gift tax rates to $100,000, the amount of the net gift. Assuming advantage were taken of the gift-splitting provisions of the law, the gift tax would come to approximately $10,000.[7]

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[5] Int. Rev. Code of 1954, § 2001.
[6] Int. Rev. Code of 1954, § 2501.
[7] *Ibid.*

As a result, how much would be removed from Beaver's estate? $110,000—although the gift tax was paid on only $100,000.

Now suppose, instead, that the gift is not made. The $110,000 remains in Beaver's estate and Beaver dies. The estate tax rate will be applied to the gross amount—$110,000—not to the net amount passing to the beneficiaries.

Thus, the estate tax is a tax on the gross amount. It is a gross tax. The gift tax is a tax on only the net gift. It is a net tax.

The fourth reason that lifetime gifts save transfer taxes relates to the fact that a gift today, while Mrs. Beaver is living, will be split if she consents, and taxed for gift tax purposes one-half to Beaver and one-half to his wife. But if no gift is made then the estate splitting provision of the law—the marital deduction—will operate in Beaver's estate only if Mrs. Beaver survives him. If Betty Beaver does not survive her husband, then Earl's entire estate, with no marital deduction, will be subject to the estate tax at one time—with no estate splitting. Thus a gift today is assured of the benefits of splitting. If a gift is not made then the benefits of splitting will not be obtained unless Earl's wife happens to survive him.

Gifts to the Wife

Before talking about gifts to the children and grandchildren, we should give some thought to the size of Mrs. Beaver's estate. We have here the not uncommon situation in which the husband has a very substantial estate, but the wife has only a small amount of separate property. Would there be any advantage in making gifts to Mrs. Beaver to try to equalize her estate with that of her husband?

Income tax wise there would be no advantage, since they are undoubtedly filing joint income tax returns.

Turning to the estate tax, however, if Betty should predecease Earl then on her death most of her $60,000 estate tax exemption[8] would go unused; and on Earl's later death, since his estate would be entitled to no marital deduction, his $420,000 estate would reach the 32 per cent estate tax bracket.

On the other hand, if Betty's estate were built up by gifts to approximately $100,000, the result then would be that if she were to predecease her husband her $100,000 estate would be exempt from estate tax to the extent of the $60,000 estate tax exemption—and the remaining $40,000 (assuming no marital deduction were available) would be subject to estate tax at rates ranging from 3 per cent to 22 per cent or an average rate of approximately 12 per cent. Yet this $100,000 of property will have come out of Earl's estate at his top 32 per cent estate tax bracket.

In short, it will generally be found that, if the husband's estate is large, gifts to the wife to bring her estate up to approximately $100,000

[8] Int. Rev. Code of 1954, § 2052.

will probably result in substantial estate tax savings if she should predecease her husband—and no tax disadvantage if she should survive him.

GIFTS TO CHILDREN AND GRANDCHILDREN

Ordinarily, in family tax planning, where substantial estates are involved, it will be particularly advantageous to transfer income-producing property to children or grandchildren. The purpose of such gifts, of course, is not only to remove the property from the donor's taxable estate, but also to shift the income from his income tax returns to those of the donees, with resulting substantial and recurring annual income tax savings.

The first important question in this connection, of course, is the non-tax question of whether such gifts are appropriate, having regard to the adequacy of the parents' estates for their own requirements, and the other facts relating to the family picture. We may assume that in the Beaver situation it will be readily agreed that a gift program is advisable.

Outright Gifts

The next important question is whether the gifts should be made outright or in another form. An outright gift is perhaps the simplest, but has some disadvantages, depending upon the age of the donee, the nature and amount of the gift property and of the donee's separate property, and management and other family considerations.

If a gift of securities or real estate is made outright to a minor, it may be impossible later to transfer that property during the donee's minority without the appointment of a legal guardian. Therefore, in the case of a gift to a minor, unless the gift is to be and remain in cash or government bonds, it is necessary to consider some of the other forms in which such a gift can be made.

Gifts of Securities to Minors in Statutory Custodianship Form

If the proposed gift is to be of securities, and if it is to be to a minor (Beaver's grandchildren), then one possible vehicle which we can use is the custodianship form authorized by a statute enacted in Ohio in 1955.[9] This statute eliminates many of the practical difficulties in making modest gifts to minors, but in a limited area only. It applies only to gifts of securities. Under this statute, a gift of securities may be made to a minor by delivering the securities to a custodian for the minor, registered in the name of the custodian if the securities are in registered form.[10] The custodian may be any adult member of the minor's family, or any guardian of the minor.

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[9] OHIO REV. CODE §§ 1339.19-.28 (1953).

[10] OHIO REV. CODE § 1339.30 (1953). If in registered form the securities should be registered as follows:

> "__________as custodian, for__________, a minor, pursuant to sections 1339.19 to 1339.26, inclusive, of the Revised Code of Ohio."

If the securities are in bearer form, then a deed of gift is required.

During the custodianship term the custodian has a broad investment power, subject only to a prudent man rule—except that he may invest only in securities and he may keep cash in bank accounts.[11] He may not invest in any other form of property. The custodianship income and principal may be applied for the support and benefit of the minor, in the discretion of the custodian, until the minor attains age twenty-one—and this without regard to the duty or ability of the parent to support the child.[12] The gift to the custodian is irrevocable, of course, and the statute provides that it gives the minor indefeasibly vested legal title.[13] At age twenty-one the property must be distributed outright to the child. If he dies before attaining twenty-one, then the property is distributed to his estate.[14]

The Internal Revenue Service has ruled that a gift to a custodian under a state statute similar to Ohio's qualifies for the gift tax exclusion.[15] It has also ruled, since the custodianship is not a trust and legal title is in the minor, not the custodian, that in general custodianship income is to be reported on the minor's individual income tax return. If, however, any custodianship income is used for the support of the minor, in satisfaction of the parents' obligation to support, such income will be taxed for income tax purposes to the person having the obligation of support. That is, he will be treated as having received the benefit of that income.[16]

This is the same rule that is applied to trust income.[17] The moral is that the custodianship income should not be used for the minor's support.

Still a third custodianship ruling has dealt with the estate tax treatment of custodianship property on the death of the donor, where he is the custodian.[18] As was previously mentioned, the custodianship statute gives the custodian the right to pay the income and principal over to the minor at any time or to withhold it from him until he attains age twenty-one. That power is so broad as to have persuaded the Commissioner—and he so ruled—that if the power is retained by the donor naming himself the custodian, then if the donor dies during the custodianship term the custodianship property will be included in the donor's estate for federal estate tax purposes. The theory of the ruling is that, having regard to the provisions of the custodianship statute, the donor has retained such broad powers over the custodianship property as to amount to a power to alter, amend or revoke the gift.

The correctness of that ruling is open to serious question.[19] The

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[11] OHIO REV. CODE § 1339.21 (1953).

[12] *Ibid.*

[13] OHIO REV. CODE § 1339.20 (1953).

[14] OHIO REV. CODE § 1339.21(A) (1953).

[15] Rev. Rul. 86, 1956-1 CUM. BULL. 449.

[16] Rev. Rul. 484, 1956-2 CUM. BULL. 23.

[17] Rev. Reg. § 1.662(a)-4.

[18] Rev. Rul. 57-366, 1957 INT. REV. BULL. No. 32.

[19] The custodianship statute expressly states that a gift in custodianship form vests legal title in the minor. Accordingly, the Commissioner's application,

moral for our purposes, however, is clear: to avoid the estate tax on custodianship property in the donor's estate, the donor should not name himself the custodian.

With someone other than the donor serving as custodian, however, and assuming the gift is of securities in modest amounts and that there will be no objection to letting the property pass to the minor outright at age twenty-one, the custodianship form does offer one convenient vehicle for making gifts to minors.

The custodianship form does have some serious limitations, however. First of all, it cannot be used for gifts of any kind of property other than securities. It cannot be used for real estate, life insurance or partnership interests. Reading the statute literally, there is no provision even for giving cash to the custodian. Secondly, the custodianship cannot continue beyond age twenty-one. This will constitute a serious disadvantage in many cases where substantial amounts of property are involved.

These disadvantages can be avoided, and numerous additional advantages can be gained, if a trust is used. Let us therefore compare two types of trust which might be employed in Beaver's gift program.

Gifts in Trust

1. Trust Satisfying the Provisions of Section 2503(c)

If property other than securities is to be the subject matter of gifts to Beaver's minor grandchildren, then one type of trust which might be employed is a trust satisfying the requirements of Section 2503(c). Such a trust will be suitable where, but for the fact that the donees are minors, the donor would be willing to make the gifts to them outright, and he is satisfied to let the property pass to them outright when they attain age twenty-one.

The reason we have a special code provision in this area relates to the gift tax exclusion. The federal gift tax law has long provided that the $3,000 annual gift tax exclusion[20] is not allowed for a gift of a future interest in property. Prior to 1954 it was well settled that when a gift is made to a trustee in a conventional trust form, the trustee having discretion to pay income and principal to the beneficiary during the term of the trust, and the trust having a termination date in the future at which time the trust property is to be distributed outright to the beneficiary, such a gift was a gift of a future interest.[21] No exclusion was allowed. Yet, prior to 1954, frequently the only satisfactory way to make a gift of property to a minor was to make the gift in trust.

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in Revenue Ruling 57-366, of the trust rules of Lober v. United States, 346 U.S. 335 (1953), and Commissioner v. Estate of Holmes, 326 U.S. 480 (1946), seems unjustified.

[20] INT. REV. CODE OF 1954, § 2503(b); see INT. REV. CODE OF 1939, § 1003(b).

[21] For a good general discussion of this subject see Fleming, *Gifts for the Benefit of Minors,* 49 MICH. L. REV. 529 (1951).

This problem was alleviated in 1954 by the addition to the law of Section 2503(c). Under that section if a gift is made for the benefit of a minor, the gift will be treated as a gift of a present interest and the gift tax exclusion will be allowed, if the property and the income therefrom may be expended by or for the benefit of the minor during minority; and if any of the property not so expended will be given to him outright when he attains twenty-one—this means that the minor must be the sole beneficiary of the trust; and if he dies before attaining twenty-one then the property will be payable to his estate or pursuant to his exercise of a general power of appointment. A trust satisfying those requirements can readily be used for a gift of an interest in real estate, or of life insurance, as well as securities.

The treatment of the income of the trust for income tax purposes will be discussed below.

Turning briefly to the estate tax treatment of such a trust, if the beneficiary of the trust should die before attaining age twenty-one, then the corpus of the trust will, of course, be part of his estate for federal estate tax purposes.[22] The more difficult question is, is there any danger of the corpus being part of the taxable estate of the donor if he should die during the term of the trust? If Beaver should make gifts to a trust satisfying the requirements of Section 2503(c), and if he should designate himself as trustee, then presumably he as trustee will have the power to decide whether and to what extent income and principal should be paid to or for the benefit of the beneficiary during the term of the trust. In that situation, namely, where the grantor as trustee has retained the discretionary power to distribute the property or to retain it in the trust for later distribution to the beneficiary, the United States Supreme Court has held that the grantor has retained a power to alter, amend, revoke or terminate,[23] with the result that if the donor dies while serving as trustee, the trust corpus will be included in his estate for federal estate tax purposes.[24] Therefore, Beaver should not serve as a trustee of the trust. In addition, we should avoid reserving any benefits in favor of the grantor.[25]

If Beaver were to name his son-in-law as trustee of a trust for one of his grandchildren, we would then have as trustee the parent who is obligated to support the child. It might be argued that then the parent has the power to use the trust funds to support his child whom he has an obligation to support, and that this constitutes a power to use the trust funds for the parent's own benefit, resulting in an estate tax danger to

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22 INT. REV. CODE OF 1954, § 2033.

23 Lober v. United States, 346 U.S. 335 (1953).

24 INT. REV. CODE OF 1954, § 2038.

25 See INT. REV. CODE OF 1954, § 2036-38. Irrespective of whether or not the grantor is a trustee of the trust, gifts made within three years prior to his death will, unless shown to the contrary, be deemed to have been made in contemplation of death. See INT. REV. CODE OF 1954, § 2035.

his estate if he should die during the term of the trust.[26] We should therefore advise Beaver that the parent having the obligation of support should likewise not be named as a trustee; or in the alternative, the trust should expressly provide that no distributions should be made discharging any legal obligation of the trustee.

2. Trusts Not Satisfying the Provisions of Section 2503(c) Because Not Limited to Minority

The Section 2503(c) trust is useful in a limited area. It too, however, has one important limitation: when the beneficiary attains twenty-one the trust must terminate and the corpus be distributed to the child outright, regardless of the amount involved. This might be regarded as a serious disadvantage. Beaver might prefer to have the final distribution of the corpus postponed beyond age twenty-one.

Indeed, in the case of Beaver's children, if the amounts to be given to them are substantial, and if it is expected that they will accumulate substantial estates of their own (as may be true in the case of the son), or if it is thought that some assistance in the way of management should be provided (as may be true in the case of the daughter), then it might be desirable to continue the property in trusts for the children for their respective lifetimes.

In drafting such trusts, we might provide for the beneficiary to receive all of the income; or we might provide for distributions of income to be determined in the discretion of the trustee. In addition, we would undoubtedly provide for distributions of trust principal from time to time to the beneficiary, and perhaps to his spouse and issue as well.[27] We could provide for the trust to terminate, in whole or in part, at a specified date, or upon the beneficiary's attaining a specified age. Or, we

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[26] Rev. Reg. § 20.2041-1(c) provides in part as follows: "A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent . . . is considered a power of appointment exercisable in favor of the decedent or his creditors." Such a power constitutes a general power of appointment and is subject to estate tax under INT. REV. CODE OF 1954, § 2041. For a discussion of this problem see CASNER, ESTATE PLANNING 184 (2d ed. 1956).

[27] Special care must be exercised in drafting the trust documents, however, if individual trustees are used, because if a beneficiary-trustee is given too broad a discretion over income or principal of the trust, the income may be taxed to him, for income tax purposes, even though he does not receive it. See INT. REV. CODE OF 1954, § 678, discussed briefly below. Under certain circumstances if a trustee is given too broad a discretion over income or principal distributions, the income may be taxed to the grantor of the trust. See INT. REV. CODE OF 1954, § 674. If the trustee is also the beneficiary and has power to distribute principal to himself, that power will not be a taxable power of appointment for estate tax purposes if it is limited by an ascertainable standard relating to his support, maintenance, health or education. INT. REV. CODE OF 1954, § 2041. Rev. Reg. § 20.2041-1(c)(2), gives several examples of powers which are limited by the requisite standard, including powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," and "support in his accustomed manner of living."

might have the trust continue for the lifetime of the beneficiary. In any event, the beneficiary could be given the power by his will to dispose of any property remaining in the trust on his death, in favor of members of his family or any other persons other than his estate or his creditors or the creditors of his estate, without requiring the inclusion in his estate, for federal estate tax purposes, of the property remaining in the trust on his death.[28]

Now, what of the gift tax exclusion for a gift to such a trust? It has been held that where the beneficiary has the right at any time to demand and receive the trust assets from the trustee, free of the trust, such a right constitutes a right to present enjoyment and qualifies the gift for the gift tax exclusion.[29] There may be several objections to giving the beneficiary so broad a power, however. Entirely apart from taxes, the grantor may be unwilling to authorize the beneficiary to take down all of the assets from the trust. If it is desired to keep the trust property out of the beneficiary's taxable estate, that objective would be lost by giving the beneficiary power to take down all of the trust property, since such a power would be a general power of appointment.[30] A practical solution for those problems is to draft the trust document in such a way as to give the beneficiary or his guardian during each year the right to demand and receive from the trustee the amount of property transferred to the trust by way of gift during the current year, limited, however, to $5,000, thus giving the beneficiary a present interest in such gifts.[31] Thus, the gift tax exclusion need not be lost on a gift to such a trust. The treatment of the income of such a trust for income tax purposes will be discussed briefly below.

What about the status of such a trust for estate tax purposes, on the death of the beneficiary, or on the death of the donor? Considering first the beneficiary, any property paid out by the trustee to the beneficiary during his lifetime, and owned by him outright when he dies, will of course be subject to estate tax in his estate at that time. On the other hand, property remaining in the trust on the beneficiary's death need not be included in his estate for estate tax purposes, even though the beneficiary has been given the benefits of enjoyment of income and of principal and the testamentary power of disposition mentioned above, assuming only that the trust has been carefully drafted and that the

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[28] INT. REV. CODE OF 1954, § 2041(b)(1).

[29] Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954); Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951); *contra,* Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952), on the ground that there was no guardian who could exercise the power for the minor beneficiary.

[30] INT. REV. CODE OF 1954, § 2041(b)(1).

[31] For a complete discussion of this subject and of the technical rules making the $5,000 limitation advisable see Cavitch, *Obtaining the Gift Tax Exclusion on Gifts in Trust: Drafting and Legislative Suggestions,* 51 MICH. L. REV. 621 (1953).

beneficiary has not otherwise been given a general power of appointment.[32]

At this point it would be well to point out to our friend Beaver that if his child were to receive property from Beaver outright, and if the child were subsequently to place such property in a trust reserving to himself the identical income and other benefits mentioned above, the child would not thereby succeed in removing such property from his taxable estate.[33] But his father, Beaver, by adopting the trust plan now, at the time when he sets out on a gift program, can give his child all of the benefits described above, yet avoid adding the gift property to his child's taxable estate, thereby accomplishing for the beneficiary the estate tax saving as well. Thus, in a very real sense, the parent here can do for his child what the child could never do for himself.

We will also wish, of course, to avoid having the trust gift thrown back into Beaver's estate for estate tax purposes when he dies. We will therefore avoid reserving any benefits in favor of Beaver, the grantor.[34] We will advise Beaver not to serve as a trustee.[35] And we will advise Beaver to take care of himself for three years so that we will not have to argue about contemplation of death.[36]

3. Income Tax Treatment of Trust Income

We have now discussed two different types of trust—a trust for minor children, which will terminate at age twenty-one; and a trust for children which will continue beyond age twenty-one. The tax treatment of the income of those trusts year by year for income tax purposes may afford a further tax advantage to be gained from the use of trusts rather than outright gifts.

Space limitations prevent consideration of the detailed rules governing the income tax treatment of trust income.[37] It will be sufficient for our present purposes to recognize that in general the amounts received by the beneficiary from the trust during the year will be treated as his income, to the extent that the trust had ordinary income in that year. Income not paid out—that is, income retained by the trustee—will be treated as the trust's income, taxed on the trust's income tax return (and, in general, not taxed to the beneficiary again when ultimately paid to him). The trust then is a newborn income taxpayer, it is taxed in general as an individual, and its income tax rate on its retained income starts in the twenty per cent bracket. This division of trust income be-

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32 See INT. REV. CODE OF 1954, § 2041(b)(1).

33 INT. REV. CODE OF 1954, §§ 2036-37.

34 INT. REV. CODE OF 1954, §§ 2036-38.

35 See Lober v. U.S., *supra* note 19.

36 See INT. REV. CODE OF 1954, § 2035.

37 The sections involved are INT. REV. CODE OF 1954, §§ 641-43, 651-52, 661-63, 665-68, 671-78. For a complete discussion see Kamin, Surrey and Warren, *The Internal Revenue Code of 1954; Trusts, Estates and Beneficiaries,* 54 COLUM. L. REV. 1237 (1954).

tween the beneficiary and the trust—that is, between two taxpayers—can result in very substantial income tax savings. Moreover, these are of course annual, recurring income tax savings.

There are two broad groups of exceptions to the general rule that income distributed to the beneficiary is taxed to him and income retained by the trust is taxed on the trust's income tax return. One of those two exceptions is the five-year throwback rule. This provision[38] is a loophole-closing measure the effect of which is, within limits, to adjust the income tax on trust income which is retained in the trust and subjected to income tax there, if in fact such income is distributed to the beneficiary within five years thereafter. The method employed, stated generally, is to provide that if in a given year a trust pays out more than its current year income (the excess is labeled an accumulation distribution), and if within the five preceding taxable years the trust has paid out less than all of its income, then the accumulation distribution in the current year (to the extent it was accumulated in the five preceding years) will be taxed as income to the beneficiary in the current year. The tax, however, is to be no greater in the current year than it would have been had the beneficiary received the income in the year when it was earned by the trust; and credit is given for the tax paid by the trust in the prior year.[39]

At first blush it might appear that the five-year throwback rule eliminates much of the advantage of dividing trust income between the beneficiary and the trust and having part reported by each. This is not true, however, because of what are in substance four restrictions upon the rule which dull its teeth as applied to most of the situations with which the practitioner deals.

The first restriction, and a very significant one, is that the throwback rule applies only if the accumulation distribution exceeds $2,000 in the particular year. Thus, if the trust has $3,000 of income and distributes $4,900, the distribution of $1,900 out of prior years' accumulated income, because it is less than $2,000, will require no adjustment under the throwback rule.[40] If, however, the trust were to distribute $5,100, the accumulation distribution being $2,100, the entire $2,100 would be subject to the five-year throwback rule. Thus, a premium is placed upon keeping the distribution in excess of current year's income to less than $2,000 a year.

The second restriction upon the operation of the five-year throwback rule is that it does not apply to income accumulated before the birth of the beneficiary or before he attains the age of twenty-one.[41]

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[38] INT. REV. CODE OF 1954, §§ 665-68.

[39] For a good discussion and example of the operation of the five-year throwback rule see CASNER, ESTATE PLANNING: CASES, STATUTES, TEXT AND OTHER MATERIALS 594-603 (2d ed. 1956).

[40] INT. REV. CODE OF 1954, § 665(b).

[41] INT. REV. CODE OF 1954, § 665(b)(1).

Thirdly, it does not apply to amounts paid to meet the emergency needs of the beneficiary.[42]

Fourthly, the throwback rule does not apply to amounts paid as a final distribution when the trust is terminated and the accumulated income, together with the principal, is paid out to the beneficiary—provided, only, that there have been no transfers to the trust within nine years preceding the date of final distribution.[43]

Those four exceptions, and in particular the $2,000 a year exception and the end distribution exception, still leave considerable area in which it will be advantageous for income to be accumulated in the trust to the extent not needed by the beneficiary, and subjected to income tax starting in the trust's twenty per cent bracket.[44]

The five-year throwback rule is one exception to the general rule that trust income will be taxed to the beneficiary to the extent distributed to him, and otherwise to the trustee. Another broad exception is a body of rules under which the trust income may be taxed to the grantor or another, even though such person received none of the trust income, on the ground that in substance he is the owner of the trust.[45] It is not possible here to do more than flag those danger areas. They should, however, be checked carefully when the trusts are being drafted.

First, if the grantor or certain other non-adverse parties have too broad a discretionary power to pay out or withhold income or principal, then the grantor will be treated as the owner of the trust, and be taxable on the trust income.[46] We can give broader discretionary powers over income and principal to an independent trustee than we can safely give to a family trustee. On the other hand, even a family trustee can be given numerous powers which are expressly spelled out in Section 674, without the grantor incurring any tax troubles.

Secondly, we must flag the danger to the grantor on account of certain so-called "administrative powers."[47] Here we have to be particularly careful if closely-held stock is to be placed in the trust.[48]

Thirdly, we must be careful of the provision treating a person other than the grantor as the owner of the trust and taxable on the income if he has the power exercisable solely by himself to take the trust income or principal.[49]

Two more danger areas involve old rules: rules taxing the grantor

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[42] INT. REV. CODE OF 1954, § 665(b)(2).

[43] INT. REV. CODE OF 1954, § 665(b)(4).

[44] See CASNER, *op. cit supra* note 39, at 599.

[45] INT. REV. CODE OF 1954, §§ 671-78.

[46] INT. REV. CODE OF 1954, § 674.

[47] INT. REV. CODE OF 1954, § 675. Sections 673, 674 and 675 are the so-called *Clifford* provisions; they stem from the decision in Helvering v. Clifford, 309 U.S. 331 (1940).

[48] INT. REV. CODE OF 1954, § 675(4).

[49] INT. REV. CODE OF 1954, § 678. *But see* Funk v. Commissioner, 185 F.2d 127 (3d Cir. 1950).

under certain circumstances if trust principal may be paid to him,[50] or if trust income may be paid to him or accumulated for him or applied to pay premiums on insurance on his life.[51]

SELECTING THE SUBJECT MATTER OF THE GIFTS

One further subject which must be considered in our gift planning is the choice between what is to be given away and what is to be retained. Since one of the reasons we are considering gifts is to increase the amount of income Beaver's family will retain after taxes, the amount of income produced by the different properties will be a factor. From this point of view we will tend to choose higher income rather than low income property—perhaps an interest in the real estate.

Another important factor is the relation between the basis of the property and its value. For example, Beaver's apartment house may have been held for a long time and have a remaining basis after depreciation of $10,000. On the other hand, the commercial property may have been recently purchased and may have a basis of $65,000. Whichever property is chosen will be valued for gift tax purposes at its present value; but the donee will not be entitled to use that value as his cost basis if that value is less than the donor's basis. Instead, the donee's basis will be the same as the donor's, increased, however, in certain cases, by the amount of gift tax attributable to such gift.[52] On the other hand, property which Beaver retains for his lifetime and which passes under his will, will take on a new basis in the hands of his heirs equal to the value at the date of his death, or at the optional valuation date if applicable.[53] Thus, we may wish to try to avoid giving low basis property.

Those are income tax considerations bearing upon the choice of the gift property. In addition, there are important estate tax considerations. What will be the effect of the gift on Beaver's estate and estate tax picture? Which items in Beaver's estate are likely to increase greatly in value? If the stock of Manufacturer's Representative, Inc., is likely to appreciate in value, perhaps some of that future appreciation should be shifted to the children by giving them some of the common stock in the company. That may call for an examination into the stock structure of Manufacturer's Representative, Inc.

To summarize briefly:

(1) We have seen that it will clearly be advantageous for Beaver to make some gifts, in order to effect both income tax and estate tax savings.

(2) In the case of Mrs. Beaver, we would tentatively recommend gifts to her to increase her estate to perhaps $100,000.

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50 INT. REV. CODE OF 1954, § 676.

51 INT. REV. CODE OF 1954, § 677.

52 INT. REV. CODE OF 1954, § 1015, as amended by the Technical Amendments Act of 1958, § 43.

53 INT. REV. CODE OF 1954, § 1014.

(3) In the case of gifts to the children and grandchildren, the amounts of the gifts and the form of the gifts will have to be decided upon after considering the over-all program.

(A) Beaver could give securities to his minor grandchildren, using the custodianship form.

(B) Since real estate or life insurance or other non-security assets might be involved, however, we might wish to use trusts for the grandchildren qualifying under Section 2503(c). Tentatively, we would recommend the trusts.

(C) Turning to Beaver's children, we will probably consider a trust gift for the daughter—possibly for the son as well. These would be trusts which would give the children income benefits, distributions of principal for support, maintenance and health, and a power of appointment in favor of their spouses and issue, and yet would avoid adding the principal of the trusts to the children's taxable estates.

(4) In drafting these trusts, we will want to keep in mind the various possible income distribution patterns and the five-year throwback rule. Finally, we will keep in mind the various danger areas which must be avoided in order that the grantor and the trustee will not encounter unexpected income or estate tax consequences on account of the trust income or principal.